Education & Skills
Funding Agency

Guidance

Academy trust management letters

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1. Who is this factsheet for?

This Good Practice Factsheet provides guidance on external auditors' management letters and communications to those charged with governance, to trustees, accounting officers, principals, executive leaders and chief financial officers (CFOs) in academy trusts (ATs). It should be particularly useful for trusts which have recently converted from local authority (LA) school status.

2. What is the status of this factsheet?

The main requirements for ATs in terms of financial management and control are set out in the Academies Financial Handbook (AFH) and the financial reporting requirements in the Academies Accounts Direction (AAD). This factsheet does not replace or modify any of those requirements. Rather it aims to provide suggestions regarding good practice. The Factsheet is one of a series, which has been produced following requests for further guidance from the sector.

3. What is a management letter?

As companies, ATs are required to prepare an annual report and accounts, which must be subject to external audit. The auditors conduct their audit in accordance with International Standards on Auditing. The focus of the audit of the accounts is to provide reasonable assurance that the accounts are free from material misstatement and therefore for the auditors to provide an audit opinion on them. However, there is another important reporting output of the audit process – the auditor's "communication to those charged with governance" (as required by International Standard on Auditing (ISA 260)); this standard covers the reporting of matters identified during the external audit, including the management letter.

The core provisions for management letters are set out in ISA 260. This requires auditors to communicate matters arising from the audit to those charged with governance. The standard states the objectives are to:

- communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit
- obtain from those charged with governance information relevant to the audit
- provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process
- promote effective two-way communication between the auditor and those charged with governance

The FRC has issued a further standard (ISA 265), describing the auditor's responsibility to communicate deficiencies in internal control that they have found during the audit and that, in their view, are sufficiently important to warrant attention.

The audit opinion on the accounts is bound by formulaic rules. It is incorporated with the accounts and a matter of public record. However, the management letter is self-standing and is not published. Management letters are less formulaic than audit opinions, more tailored to the client's circumstances and therefore should provide helpful insights on and recommendations to improve the AT's governance, accountability, risk management and control arrangements for the AT's leaders.

4. Who are the "relevant persons"?

In ATs this means trustees and the key management personnel such as the CEO. Although ISA 260 does not specify precisely to whom the auditor should address the communication, clearly it must be with the senior leadership, including directors and the audit committee. The persons to whom the communication will be directed can be clarified in the engagement letter. In ATs it will include at least the trustees and the CEO / Accounting Officer, but it is not limited to them. ISA 260 states:

"For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity…".

5. Core matters to be communicated

The ISAs provide details as to what should be covered in management letters. In the context of ATs, the main areas are likely to be as follows.

5.1 Matters relating to the audit opinion

The auditor must consider the type of issues that should be communicated. ISA 260 provides some guidance, including:

- the overall approach and scope of the audit, including any limitations of scope
- the accounting policies, and any changes to them, that could materially affect the financial statements
- adjustments discovered by the audit that could materially impact the financial statements
- material events or uncertainties which could jeopardise going concern status, and which require disclosure in the financial statements
- disagreements with management over accounting treatments or disclosures
- any expected modifications to the audit opinion
- material weaknesses discovered in the internal systems and controls

The above are referred to as "findings from the audit".

5.2 Other matters

The management letter should not just contain audit findings but will cover some more evaluative audit-related issues, which the auditor wishes to raise, such as:

- any threats to independence and objectivity and any safeguards adopted
- explanations of the audit approach used such as the concept of materiality and its application to the audit
- the risks identified and the likelihood of them materialising
- a review of the contents of the management representation letter
- recommendations to improve the client's system of internal controls

In addition to the content required by the auditing standards, the AAD requires that the management letter addresses:

- the auditor's approach to the audit
- the areas covered by the audit
- any audit findings, including any significant concerns, including ratings of their importance/risk
- any audit recommendations
- the AT's response to the recommendations including timescales
- the status of any audit recommendations from the prior year

The AAD also requires that the management letter addresses regularity findings, including any irregularity identified where the auditor has concluded that it is not material by virtue of value or nature. In respect of each regularity issue:

- the issue (including a rating of the risk/importance and financial impact)
- implication/consequence
- recommendation
- management response (including timescale for change)

6. Timing

The purpose of communicating these matters is to bring them to the leadership's attention, so it can take necessary action. If the leadership was previously unaware of control weaknesses, it can now tackle them. If the CFO did not know that an accounting treatment did not comply with financial reporting / accounting requirements, they can address the issue. The process leading to the management letter provides early warning to management so that the issues can be addressed.

The auditor must communicate matters to the leadership to allow it to react to them promptly. Of course, sometimes this will take place informally and be face to face rather than just set out in a letter. But there is a risk that identified control deficiencies are not brought to the client's attention as soon as they might have been. In the absence of more informal communication, waiting to send a management letter with the final accounts is unlikely to be sufficiently prompt to comply with the ISAs. So, even if at the planning stage the auditor identifies a significant financial reporting issue or significant weakness in the client's internal controls, the issue should be raised then. At the very least, audit findings relevant to the accounting and financial reporting function must be communicated before the approval of the financial statements by the AT board. This provides the opportunity for the AT to correct any material errors before the audit report is issued, so avoiding modification of the audit opinion itself.Responding to the management letter

Management letter findings are about improvement not judgement. A list of findings is not a report on the AT's weaknesses nor a statement that the leadership is deficient.

In June 2018 Lord Agnew, Parliamentary Under-Secretary of State for the School System, published a letter to academy auditorsabout increasing awareness of best practice in AT financial management and governance. Of audit management letters, he said:

"…are extremely useful tools for a board. We would like to see the recommendations made by auditors being implemented in a timely manner with scrutiny at board level to ensure that this is the case"

Management letters provide helpful information that boards can use to ensure ATs are properly governed and managed. A defensive response is not helpful. Understandably, boards will wish to protect their reputation, but acknowledging the issue, accepting the recommendation and detailing an action plan will best address the concerns of regulators such as ESFA. Broadly, there are 3 types of response:

6.1 Agreement and corrective action plan

Agreement is generally the best approach. If the board agrees with the finding, then it should say so, detail the corrective action, identify the individual responsible for it and the target completion date. More complex findings may take time, but should be addressed as soon as possible; at the same time there should be a commitment to an early completion date for simpler ones. The response should provide enough detail to satisfy any reader that the implementation plan is sound. The auditors will conduct follow-up testing and will check that the AT has done what it has said it would.

6.2 Disagreement

There may be exceptional circumstances, where there is justification for an AT to disagree with an audit finding. However, a disagreement with the auditor on a significant matter is likely to raise a red flag with regulators such as the ESFA and will prompt the auditor to respond with further explanation of the finding, potentially rebutting the disagreement and possibly inviting regulatory scrutiny.

It may be possible that an auditor has made an error of fact or that there are alternatives to the recommendation they have made. Ideally, these conversations should occur before the management letter is drafted. A written response to a management letter finding is not the best place to document disagreement with the auditor. If there are occasions when disagreement is valid and substantiated, the response should be measured, clear and thorough, citing specific, evidence for the disagreement or alternative corrective action.

6.3 No response

The ISAs do not include any obligation to respond, but the AAD does and, in any event, the lack of a response may be taken by ESFA and others as the AT failing to take the audit process seriously and showing resistance to feedback and accountability.

7. The form of communication

ISA 260 sets out how communication should take place. For ATs the AAD requires a written management letter to be sent to the ESFA with the accounts, so in practical terms the communication will always be in writing. The AAD also requires that both audit and regularity matters are addressed. The process involves a two-way dialogue and the AT leadership should have the opportunity to respond to the auditor regarding the matters raised.

Auditors must issue management letters even if there are no significant matters they wish to bring to the attention of the AT, stating that there are no significant control or other findings from the audit to be communicated. The management letter should, at least address, the matters referred to in Section 5.1 above, even if the feedback is positive.

The ISAs do not prescribe a set format for the management letter, and each accountancy firm is likely to have its own letter format based upon its standard working practices. However, ATs could ask for the letter to be in a form that is most useful to them and this is a matter to be discussed with the auditor before acceptance of the letter of engagement. However, while there may be no standard, sector-wide format, management letters for ATs are likely to the following:

- scene-setting which describes the audit approach
- qualitative aspects of the AT's accounting practices and financial reporting
- any significant difficulties
- any expected modifications to the auditors' report
- a section that addresses the auditor's observations from this year's audit and recommendations in each area. These matters will have been discussed with management and its response will be included
- a summary of matters previously raised in management reports that have not yet been implemented/resolved and their current status
- a summary of matters previously raised in management reports that have been addressed during the current financial year
- their housekeeping suggestions (not necessarily weaknesses)
- any adjusted misstatements
- any unadjusted items noted during the audit which were immaterial to adjust

- any other relevant matters relating to the audit
- a report on regularity and regularity exceptions
- a forward look considering upcoming policy or regulatory changes
- a disclaimer explaining that the management letter has been prepared for the sole use of the AT, must not be disclosed to third parties, quoted or referred to without consent and that no responsibility is assumed to third parties

The auditor should grade their management letter observations as follows:

- high risk: issues where there is a risk of significant financial impact on the business that must be addressed immediately
- medium risk: issues where there is a risk of moderate financial impact on the business, such as a control failure or the absence of a control in an area of moderate risk. These should be addressed soon
- low risk: issues that relate to minor control deficiencies or enhancements in control efficiency. These should be addressed within an agreed timescale

For each category of observation, we might expect:

- observation: a brief description of the point, with any necessary background information,
- risk / impact: an explanation of the specific risk arising and potential impact, as well as its relative rating (H/M/L)
- recommendation: a description of remedial action and which must be viable in the context of the AT. It should also state the benefits of implementing the recommendation
- management response: to be agreed with management
- action: a plan for the implementation of the agreed recommendations, naming the member of staff responsible for implementing each of them and the target date

The ESFA guidance for academy trusts to submit their annual accounts states that certain management letter information should be included in the academy trust Accounts Submission Cover Sheet, namely:

- the number of control recommendations reported by the auditor within their management letter:
  - where they have reported any control recommendations, further relevant information
  - if they have not reported anything then confirmation that the number is "0"
- the number of any unactioned recommendations that had also been made in the prior year's management letter
- whether the auditor has assigned a priority rating to each finding and, if so, how many recommendations have been assigned to respective high, medium, low or equivalent priority ratings.

8. ESFA review of management letters

The AAD requires ATs to submit management letters to the ESFA with the audited annual report and accounts.

Management letters are also a useful tool for the ESFA. The ESFA considers both the findings and the management responses carefully. A minimal management response such as "noted" may suggest a less than serious consideration of the finding and, if there is a pattern of audit findings from previous years remaining unaddressed, then the ESFA may become concerned about the importance the AT places on external audit and matters raised by external auditors.

If there is a pattern of similar findings coming up in a particular AT year after year, there may be consideration of whether the auditor in question is having an impact or whether there is a sufficient relationship of mutual respect between the AT and auditor.

9. Conclusion

The management letter should be viewed as an important reporting output of the external audit. It should provide management and boards with both assurance and helpful advice and recommendations on governance, accountability, risk management, controls and financial accounting / reporting matters. Used properly, the management letter can be a useful tool to help AT leaders discharge their responsibilities and provide tangible benefits from the external audit process.

10. Acknowledgements

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